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TAGS: PGOV ECON ENRG EINV KZ
SUBJECT: KAZAKHSTAN: AES AGREES TO EARLY BUY-OUT OF EKIBASTUZ
MANAGEMENT CONTRACT

REF: (A) 08 ASTANA 2177 (B) 08 ASTANA 2086

ASTANA 00000555 001.2 OF 003

¶1. (U) Sensitive but unclassified. Not for public Internet.

¶2. (SBU) SUMMARY: On March 20, Kazakhstan's largest private mining company, Kazakhmys, terminated after just 15 months a three-year management agreement for U.S. power company AES to run the Ekibastuz coal-fired power plant. The contract, which was scheduled to end on December 31, 2010, would have paid AES $381 million if the company had met certain revenue targets. Instead, AES will receive $80 million in April 2009 and $102 million in January 2010. AES Kazakhstan publicly called the early termination a "mutual decision that will benefit both AES and Kazakhmys." In private conversations with us, company officials blamed the economic crisis for the termination, and also suggested that state-owned company Samruk-Energo played a role in the decision. An industry analyst argued that AES no longer has anything of value to contribute to the development of Kazakhstan's energy sector. END SUMMARY.

AES'S EARLY DISMISSAL

¶3. (U) On March 20, Kazakhstan's mining giant Kazakhmys announced the early termination of a management contract with AES for the latter to run the Ekibastuz GRES-1 coal-fired power plant as well as the Maikuben coal mine. In May 2008, Kazakhmys acquired Ekibastuz and Maikuben from AES for $1.5 billion. Under the terms of that agreement, AES was to operate Ekibastuz on behalf of Kazakhmys until December 31, 2010. The three-year management contract was to pay AES up to $381 million if the company met targets for revenue, profitability, and capital improvements. Under the terms of the buy-out, however, Kazakhmys will pay AES $80 million in April based on 2008 results and $102 million in January 2010. Kazakhmys's CEO thanked AES for facilitating the management transition and said, "This agreement reduces our cash commitments, which is welcome in the current environment. It should also allow us to create a more integrated approach to all of our power facilities, which together

represent over 20 percent of Kazakhstan's power output." Since 1996, AES has invested over $200 million in modernization programs bringing into operation more than 2,000 megawatts of generation capacity at Ekibastuz.

ECONOMIC CONDITIONS BLAMED FOR EARLY TERMINATION

¶4. (SBU) On March 24, AES Vice President Mike Jonagan told Energy Officer that the early buy-out of the management contract was the inevitable result of the economic crisis and the government's decision to fix electricity tariffs for the next seven years. Jonagan confirmed that under the terms of the original management contract, AES would have been paid $381 million in total if financial performance targets were met. According to Jonagan, in 2008, the Ekibastuz power station delivered strong financial results, which guaranteed a significant payout to AES for that period. In 2009, however, Jonagan said the deepening crisis "made it very unlikely" that the company would achieve the minimum financial threshold for AES to receive payment. Therefore, he said, both parties understood that it was just a matter of time before AES itself terminated the agreement to ensure that it received at least the minimum payout possible. Interestingly, Jonagan did not blame the government's pending anti-trust ruling against AES -- a matter which the company may still take to international arbitration -- for the early dismissal (reftel A). Indeed, he sounded positively upbeat about the announcement, saying, "We are parting ways under fairly good terms and with minimal hard feelings. The economic crisis really killed the business, which means they are postponing the capital expansion program. We basically became redundant in the economic environment that evolved -- something no one predicted when we signed the contract in December 2007."

¶5. (SBU) During a March 26 meeting with the DCM, AES Country Manager Doug Herron speculated that Kazakhmys was eager to exit the agreement due to its own cash flow constraints. Kazakhmys has lost

nearly 90 percent of its market value in the last year and, according to Herron, the company reported no earnout at all from Ekibastuz in 2008. Herron said that some AES corporate officials are concerned that Kazakhmys will not meet its next scheduled payment to AES, although he himself was not worried, because AES has a letter of credit guaranteeing payment. Herron also said the government's regulation of electricity tariffs will adversely affect the profitability of the power plant and AES's other power companies in Kazakhstan. However, he added that the tariff regulation does not unfairly discriminate against AES by setting a lower rate for their hydropower assets, as did an initial draft. Herron also noted that the central government's decision to fix electricity tariffs nationwide means that local governors will no longer be able to request preferential treatment for power consumers in their oblasts. "That used to be a terrible problem," said Herron. "Now, with the regulation setting capped rates by fuel type, there's much less local interference."

GOVERNMENT PLANS TO TAKE BACK ENERGY ASSETS

¶6. (SBU) Herron noted that state-owned Samruk-Energo, which is a wholly-owned subsidiary of the Samruk-Kazyna National Welfare Fund, plans to acquire 40 percent of Ekibastuz from Kazakhmys. He suggested that as a result, Samruk-Energo may also have played a role in pressing Kazakhmys to terminate AES's management contract early. (NOTE: In February 2008, when AES announced the sale of its interest in the Ekibastuz power plant and the Maikuben coal mine to Kazakhmys, Prime Minister Karim Massimov ordered Samruk-Energo to negotiate with Kazakhmys for an ownership stake in Ekibastuz. In October 2008, Kazakhmys and Samruk-Energo signed a memorandum of understanding agreeing to joint ownership of Ekibastuz and Maikuben. Samruk-Energo Managing Director Alexander Li said at the time that the company would need six more months to complete the necessary due diligence and report its findings to the government, and approximately one year to complete the deal. In November 2008, Kazakhmys asked the government to expedite its acquisition of Ekibastuz and the Maikuben, warning that it did not have sufficient funds to repay the loan it took to finance the acquisition from AES. END NOTE.)

AES HAD "NOTHING OF VALUE" TO CONTRIBUTE

¶7. (SBU) On March 24, Moscow-based energy consultant Paul Boyne told Energy Officer that AES was being "run out of the country" because they no longer had anything of value to contribute to the development of Kazakhstan's power sector. Boyne, who has worked as an advisor to Samruk-Energo, said, "All the equipment at Ekibastuz is Russian. All the expertise is with the local staff, not the AES management team. And AES can't arrange any capital investments for the plant, so they are totally useless." Boyne said AES knew it could not fulfill the goals in the management contract and should consider itself fortunate to walk away with such a large payout. "I wasn't surprised that AES left," he said. "The only surprise to me is how fast it happened."

SOUTH KOREANS INVEST IN POWER SECTOR

¶8. (U) On a separate but related note, the Korea Electric Power Corporation announced on March 25 that a consortium involving Samsung C and T Corporation was selected as the prime bidder for construction of a $2.5 billion thermal power plant in Balkhash, in eastern Kazakhstan. The consortium plans to finalize a formal deal with Samruk-Energo in 2010, with the aim of completing a plant with a capacity of 1,200-1,500 megawatts by 2014. The consortium will own 75 percent of the new venture and operate the plant once it is built in Balkhash.

¶9. (SBU) COMMENT: Unlike previous government decisions affecting AES, in this case, the company has not asked for sympathy or support from the U.S. government. AES seems genuinely satisfied to exit its Ekibastuz management contract at the half-way point, with

approximately half of the revenue it had planned to collect. AES's country manager even called the early buy-out "the cream on top" of the billion-dollar sale of the power plant to Kazakhmys in 2007. However, the transaction does make one wonder where AES will go from here. The company's anti-trust dispute looks headed for international arbitration, Samruk-Energo has replaced AES at Ekibastuz, and Korean rival Samsung is grabbing headlines and winning billion-dollar contracts to build new power plants. AES now has only two hydropower concessions until 2019, and two combined heat-and-power plants that even they admit no one wants, as their strategic presence in the region. END COMMENT.

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